[redacted]

INDEX

CITATIONS

Cases:

In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 769

PENNSYLVANIA POWER & LIGHT COMPANY,
PETITIONER

v.

FEDERAL POWER COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the circuit court of appeals (R. 592–607) is reported in 139 F. (2d) 445. The opinions and orders of the Commission are set forth in the record (R. 483–527; 541–542; 560–564).

JURISDICTION

The judgment of the circuit court of appeals (R. 607) was entered on December 7, 1943. A petition for rehearing was denied on February 11, 1944 (R. 621). The petition for a writ of

certiorari was filed on March 8, 1944. Jurisdiction of this Court is invoked under Section 313 (b) of the Federal Power Act (49 Stat. 860, 16 U. S. C. 825*l*) and Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the Federal Power Commission, in determining the "actual legitimate original cost" of petitioner's licensed project, properly disallowed as items of cost profits inuring to petitioner's parent holding company under construction and service contracts with petitioner.

2. Whether the Commission properly required petitioner to charge the disallowed items to surplus.

STATUTES INVOLVED

The relevant provisions of the Federal Water Power Act of 1920 and the Federal Power Act of 1935 are set forth in the Appendix, *infra,* pp. 16–19.

STATEMENT

Under a license dated September 29, 1924, issued by the Federal Power Commission pursuant to the Federal Water Power Act of 1920,[1] petitioner, the Pennsylvania Power & Light Company, constructed the Wallenpaupack hydroelectric project on the Lackawaxen River in Pennsylvania (R.

[1] By Title II of the Public Utility Act of 1935 (49 Stat. 838), the Federal Water Power Act was amended and made Part I of the Federal Power Act of 1935.

5–10). As required by section 4 (b) of the Act and by the license (R. 7), petitioner in 1928 filed with the Commission a statement of the claimed "actual legitimate original cost" of the project, which, as supplemented by subsequent annual statements of additions, betterments, and retirements, totalled $9,148,755.88 as of December 31, 1934. After service upon petitioner of a report showing the results of an audit made by the Commission's staff (R. 12–35), and extensive hearings thereon, the Commission determined the actual legitimate original cost of the project as of December 31, 1934, to be $8,579,186.15; the balance of petitioner's claimed cost was disallowed (Commission's Opinion No. 68 and orders of April 14, 1942, as amended September 29, 1942; R. 483–527, 562–564). Petitioner was directed to set up its accounts to reflect the Commission's determination by removing the disallowed amounts from its project accounts and charging them to various accounts, principally the earned surplus account (R. 524–527). As to the issues here involved, petitioner's application for rehearing (R. 528–540) was denied by the Commission (R. 541–542), and on a petition for review, the Commission's determination was upheld by the Circuit Court of Appeals for the Third Circuit (R. 607).

The disallowances of which petitioner complains in this Court (Pet. 5–6) are limited to the profits ($84,555.75) obtained by petitioner's parent holding company, Electric Bond and Share Company

(Bond & Share), for engineering services furnished to petitioner under a "service" contract, and the profits ($197,596.35) derived by Bond & Share from a cost-plus construction contract between its wholly-owned subsidiary, Phoenix Utility Company (Phoenix), and petitioner.

The following facts relating to the disallowance of these items were found by the Commission and are uncontested here:

Petitioner was organized by Bond & Share on June 4, 1920, by consolidating certain previously acquired Pennsylvania utility companies (R. 497; 54). Bond & Share owned only 15% of the voting stock of a sub-holding company controlling petitioner, but maintained complete working control over petitioner through a voting trust, interlocking directorates, and servicing arrangements (R. 498, 499; Pet. 10). As to the engineering and construction work in question here, there was an absence of arm's length bargaining between Bond & Share and petitioner (R. 495).

Under a contract with petitioner, the engineering department of Bond & Share provided designs and specifications for the project, in return for which petitioner reimbursed Bond & Share for the salaries paid to its employees who did the work, plus approximately 95% of the salaries to cover overhead (R. 500). The Commission found that the properly allocable overhead was 50% of the salaries (R. 509), and that the remaining 45% of the overhead charge constituted a profit of $84,-

555.75 to Bond & Share, which the Commission disallowed under its rule that profits to an affiliate are not to be included within "actual legitimate original cost" (R. 509–511).

Under a contract calling for cost plus a 3% fee, Phoenix, a wholly-owned subsidiary of Bond & Share, performed construction work on the project (R. 565–569). Phoenix had no personnel or equipment of its own and did not operate with its own funds; it operated only within the Bond & Share system, obtaining none of its contracts as a result of competitive bidding; its officers and employees were supplied and paid by Bond & Share or operating companies in the system; and its construction equipment was purchased with funds of the operating company (R. 491). When it undertook the construction work for petitioner, Phoenix created an organization under its own name, the salaries being paid by petitioner; and the profits obtained by Phoenix were immediately siphoned into Bond & Share's treasury (R. 493). The Commission further found that Phoenix was merely the separately incorporated construction department of Bond & Share, interposed for the purpose of exacting construction fees from operating companies controlled by Bond & Share (R. 495). The Commission therefore held that the 3% fee of $197,596.35 over costs, paid to Phoenix by petitioner, was a profit to an affiliate and did not constitute a part of the "actual legitimate original cost" of the project (R. 495).

On petition for review, the court below affirmed the Commission's order (R. 593–607).

ARGUMENT

Petitioner contends that the Commission is not authorized to disallow profits to petitioner's affiliates as not within "actual legitimate original cost," and to direct that the disallowed amounts be charged to earned surplus. We submit that this contention was properly rejected by the court below.

1. The Commission's exclusion of Bond & Share's profits from the "actual legitimate original cost" of petitioner's licensed project was justified under sections 4 (b) and 3 (13) of the Federal Power Act of 1935. Section 4 (b) authorizes and empowers the Commission "to determine the actual legitimate original cost of and the net investment in a licensed project." Section 3 (13) defines "net investment" in a project to mean "the actual legitimate original cost thereof as defined and interpreted in the 'classification of investment in road and equipment of steam roads, issue of 1914, Interstate Commerce Commission', plus similar costs of additions thereto and betterments thereof * * *. The term 'cost' shall include, insofar as applicable, the elements thereof prescribed in said classification * * *." Both of these provisions are derived from sections 3 and 4 (a) of the Federal Water Power Act of

1920, 41 Stat. 1063, with which they are substantially identical. (See Appendix, pp. 16–19, *infra*.)

The "classification of investment in road and equipment of steam roads" was issued in 1914 by the Interstate Commerce Commission in compliance with the requirement of the Valuation Act of 1913, 37 Stat. 701, that the "original cost" of the physical properties of carriers subject to its jurisdiction be investigated and determined by the Commission (18 Code of Federal Regulations, Part 103, pp. 209, *et seq.*). The classification provided, so far as may be relevant here, that "the cost of construction shall include * * * contract work" (*id.*, p. 216), and that "cost of contract work includes amounts paid for work performed under contract by other companies" (*id.*, p. 217). It contained no provision, however, dealing with situations in which the construction work was done by an affiliated company. And when Congress enacted the Federal Water Power Act of June 10, 1920, the Interstate Commerce Commission had made no rulings upon the question whether construction profits to affiliates should be allowed. *Texas Midland R. R.*, 75 I. C. C. 1, 176 (1918), upon which petitioner relies, did not involve that question. As the court below held, the issue in that case was "whether in determining the cost of a project the amounts actually expended by the carrier or the fair average cost must prevail," and the Commission "ruled in favor of the amounts actu-

ally expended" (R. 597). Compare *Kansas City Southern Ry.*, 75 I. C. C. 223, 233 (1919).

After the passage of the Federal Water Power Act of 1920 the Federal Power Commission formulated and consistently applied its "no profit to affiliates" rule. *E. g., Alabama Power Company, Licensee* (Mitchell Dam), 1 F. P. C. 25, 31, 39, P. U. R. 1932 D, 345, 352, 360; *Chelan Electric Company, Licensee,* 1 F. P. C. 102, 108, P. U. R. 1933 E, 332; *Louisville Hydro-Electric Co., Licensee,* 1 F. P. C. 130, 133–136, 1 P. U. R. (N. S.) 454, 458–461. The rationale of the rule was thus stated by the Commission in its opinion in the *Louisville Hydro-Electric* case, *supra,* at 136:

> * * * Where there is admitted control of both the licensee and the service company and where, as here, the two companies are virtually departments of an integrated system, the Commission must, under the provisions of the Federal Water Power Act, disregard the contract and hold that cost to the licensee can be no more, though it may under certain circumstances be less, than the cost of such service to the service company. * * *

These decisions were reported annually to the Congress, and in its Fourteenth Annual Report, transmitted to Congress on December 1, 1934, the Commission called attention to the holding company problem and the interpretation which it had given to the phrase "actual legitimate original cost":

> * * * the Commission has sought to protect the public interest by denying claims of costs for services to the licensee, performed by holding companies or affiliated service corporations, pending production by the licensed operating company of the original records of cost. In considering such claims the Commission holds that "cost to the licensee can be no more, though it may under certain circumstances be less, than the cost of such service to the service company" (p. 2).

Thereafter Congress enacted the Federal Power Act of 1935, 41 Stat. 1063, which retained without change the statutory criterion of "actual legitimate original cost" in section 4 and its definition in section 3. Such reenactment of the cost criterion in the Federal Water Power Act of 1920 implies Congressional acquiescence in the Federal Power Commission's long-settled administrative construction of the phrase "actual legitimate original cost" to exclude the allowance of profits to affiliates in determining cost. Here, as in *Inland Waterways Corp.* v. *Young*, 309 U. S. 517, 525, "the responsible and pervasive practice of public officers bent on safeguarding the public interests ought to carry the day even were the issue more in doubt than we believe it to be." The Federal Power Commission since 1935 has adhered to the "no profit to affiliates" rule, consistently disallowing such items as proper elements of cost. *E. g., Northern States Power*

Company, Licensee, 1 F. P. C. 329, 344–345; *Lexington Water Power Company, Licensee,* 1 F. P. C. 430, 435–469; *Alabama Power Company, Licensee,* 2 F. P. C. 432, 443–444, 41 P. U. R. (N. S.) 449; *Puget Sound Power & Light Company, Licensee,* F. P. C. Op. 78, July 28, 1942.

In providing in section 3 of the 1920 Act that "actual legitimate original cost" should be regarded "as defined and interpreted" in the classification of railroad properties issued by the Interstate Commerce Commission in 1914, Congress clearly did not intend to bind the Federal Power Commission and the courts in construing that phrase to whatever interpretations might subsequently be made by the Interstate Commerce Commission in determining the valuation of properties owned by carriers. (See Hearings before the House Committee on Water Power (65th Cong., 2d Sess.), March 18 to April 4, 1918, Part I, p. 44.) It is immaterial, therefore, whether subsequent to the enactment of the Federal Water Power Act of 1920 the Interstate Commerce Commission failed to differentiate between profits of affiliated and non-affiliated contractors.[2] As the court below noted

[2] With the exception of *Texas Midland Railroad,* 75 I. C. C. 1 (1918) which admittedly did not involve contracts between affiliates (Pet. 7), all the I. C. C. decisions cited by petitioner were rendered subsequent to 1920. See Pet. 8. Since the disallowance of profits here was based on sections 4 (b) and 3 (13) of the Federal Power Act, these considerations are dispositive of petitioner's contention (Pet. 9) that the Com-

(R. 598), these cases "have no bearing on the question before us since they could not have been in the contemplation of Congress when it passed the [1920] act."

As the court below pointed out, profits to affiliated companies are neither "actual" nor "legitimate" items of cost, since "payment of profits to an affiliated corporation may for all practical purposes be the equivalent of payment of profits to the licensee itself" (R. 599).

Bond & Share's actual investment in petitioner was small (only 15% in an intermediate holding company which owned petitioner's common and most of its voting stock), and it exercised complete control by means of a voting trust, interlocking directorates, service contracts, and other arrangements (Pet. 10).[3] Normally Bond & Share would receive only a fraction of any dividends which petitioner declared from its operating income (R. 490), and to realize more substantial profits, Bond & Share applied its "fee system" to pe-

---

mission was retroactively applying the "no profit to affiliates" rule of the S. E. C. embodied in section 13 of the Public Utility Holding Company Act (15 U. S. C. 79m), and in disregard of the line of decisions which deal with the reasonableness of the affiliates' charges. None of the cases relied upon by petitioner involved the statutory standard of "actual legitimate original cost" as applied to licensees.

[3] The so-called Mitchell Plan under which Bond & Share exercised control of subsidiaries with little or no actual investment is described in *In the Matter of Electric Bond and Share Company, et al.*, S. E. C. Holding Company Act Release No. 3750.

titioner. Through its control over petitioner, Bond & Share obtained the execution by petitioner of cost-plus and other contracts with itself and Phoenix, under which construction, engineering, and other services were rendered to petitioner at fees and rates fixed without any arm's length dealing (R. 489–511). As the court below characterized the relationship of the companies, "Phoenix and the licensee are thus both puppets in the Electric Bond and Share system" (R. 601).

To permit petitioner's asset accounts to reflect an amount representing merely a profit to its affiliated companies fixed without any element of independent negotiation, would result in the "inflation of cost" which Congress intended to prohibit by establishing the standard of "actual legitimate original cost" for licensees. See *Alabama Power Company* v. *McNinch*, 94 F. (2d) 601, 618 (App. D. C.).[4]

The construction given the statute by the court below is in accord with that consistently made by all of the courts which have considered the matter. Whenever the question has arisen, whether under

[4] Actual legitimate original cost controls the price which the Government must pay upon recapture of the project at the expiration of the license (§ 14). It is also the basis for expropriation of excess profits (§§ 10 (d) and (e)), compensation for wartime or emergency use of the project by the United States (§ 16), and rate regulation by the Commission (§§ 19 and 20). Cf. *United States* v. *Appalachian Electric Power Co.*, 311 U. S. 377.

the Federal Water Power Act of 1920 or the Federal Power Act of 1935, the courts have uniformly sustained the Commission's disallowance of profits to affiliates in determining actual legitimate original cost. *Alabama Power Company* v. *McNinch,* 94 F. (2d) 601, 608, 615, 618 (App. D. C.) (under 1920 Act); *Alabama Power Company* v. *Federal Power Commission,* 128 F. (2d) 280, 284 (App. D. C.), certiorari denied, 317 U. S. 652 (under 1935 Act); *Alabama Power Company* v. *Federal Power Commission,* 134 F. (2d) 602, 609 (C. C. A. 5), (under 1935 Act); *Puget Sound Power & Light Company* v. *Federal Power Commission,* 137 F. (2d) 701, 703 (App. D. C.), (under 1935 Act); *Niagara Falls Power Company* v. *Federal Power Commission,* 137 F. (2d) 787, 793–794 (C. C. A. 2), No. 448 Oct. Term 1943, certiorari denied, November 22, 1943 (under 1935 Act).

2. The Commission's requirement that petitioner charge the disallowed items to earned surplus was properly sustained by the court below. In this aspect the case "presents only a question of proper accounting." *Northwestern Electric Company* v. *Federal Power Commission,* No. 195, this term, decided January 31, 1944. A sound and reasonable manner of removing from the project accounts an item not representing actual legitimate original cost is to charge the improper item to surplus. Substantially identical accounting procedure has uniformly received judicial approval. *Alabama Power Company* v. *Federal*

Power Commission, 128 F. (2d) 280, 285–286 (App. D. C.), certiorari denied, 317 U. S. 652; *Louisville Gas & Electric Company* v. *Federal Power Commission,* 129 F. (2d) 126, 133–134 (C. C. A. 6), certiorari denied, 318 U. S. 761; *Niagara Falls Power Company* v. *Federal Power Commission,* 137 F. (2d) 787 (C. C. A. 2), No. 448, Oct. Term 1943, certiorari denied November 22, 1943; *Northern States Power Company* v. *Federal Power Commission,* 118 F. (2d) 141, 144 (C. C. A. 7); *Alabama Power Company* v. *Federal Power Commission,* 134 F. (2d) 602 (C. C. A. 5); *Puget Sound Power & Light Company* v. *Federal Power Commission,* 137 F. (2d) 701 (App. D. C.). And this Court has recently upheld the elimination of an erroneous asset item by charges to surplus. *Northwestern Electric Company* v. *Federal Power Commission, supra.*

Petitioner urges that the questions presented are important, involving 30 hydroelectric projects of Bond & Share subsidiaries situated in several circuits (Pet. 14). We suggest, however, that review of these issues by this Court at the present time is unwarranted by the circumstances. As has been noted (*supra,* pp. 13–14), there is no conflict in the decisions of the lower courts. The authority of the Commission to apply its "no profit to affiliates" rule in determining cost has been upheld by every court which has considered the question. In view of the correctness of this construction of the

statute, as well as the absence of any conflict in the decisions, further review at this time is not called for.

CONCLUSION

It is respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FAHY,
Solicitor General.
FRANCIS M. SHEA,
Assistant Attorney General.
DAVID L. KREEGER,
Special Assistant to the Attorney General.
PAUL A. SWEENEY,
Attorney.
CHARLES V. SHANNON,
General Counsel.
HOWARD E. WARRENBROCK,
Assistant General Counsel.
Federal Power Commission.

MARCH 1944.